

Beyond Market Access

The New Normal of Preferential Trade Agreements

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Abstract

This paper takes stock of the growing success of preferential trade agreements. It revisits what are the defining characteristics of modern preferential trade agreements, which are typically pursued for a diverse array of motives. In particular, the market access justification traditionally used to analyze the desirability and impact of preferential trade agreements misses increasingly important dimensions. The “Beyond Market Access” agenda of preferential trade agreements

presents a new and broad set of deep regulatory and policy issues that differs in substance from the removal of tariff and quantitative barriers to trade. Issues related to preferences and discrimination, as well as the nature and implementation of commitments acquire a different meaning in deep preferential trade agreements. This change of paradigm presents significant opportunities and challenges for reform-minded developing countries to use preferential trade agreements to their own advantage.

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**Beyond Market Access:
The New Normal of Preferential Trade Agreements**

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1 A Preference for Deep Integration

Economists have repeatedly warned against them, NGOs have fought them, and some governments have grudgingly (at least in appearance) signed them. Yet, in the past 20 years growth in the number of preferential trade agreements (PTAs) has been unabated. Even more strikingly, their scope has broadened. Deep integration provisions in PTAs have now become ubiquitous.

While multilateral liberalization is ultimately the most economically efficient way to guarantee market access and global participation in international trade, gaining preferential market access or preserving existing preferences has remained an important individual motivation for negotiating or acceding to PTAs. However, with the liberalization of trade around the world and the related diminishing size of preferential rents, the growing success of PTAs cannot be only explained by traditional market access motives (even factoring in the possible substitution of tariffs for other less transparent forms of protection). Countries are also interested in a host of other objectives, including importing higher policy standards, strengthening regional policy coordination, locking-in domestic reforms, and even addressing foreign policy issues (Schiff and Winters, 2004; Hoekman, 2010).

This translates in a beyond-market-access ambition of many PTAs. Increasingly the focus includes agreement on a broad set of rules and discipline governing areas such as investment regimes, technical and sanitary standards, trade facilitation, competition policy, government procurement, intellectual property, environment protection, migration, labor rights, human rights, and other so-called “behind the border” issues.

Ambition in recent PTAs expresses itself in two ways: the first one pursues what can be termed a WTO-plus agenda in policy areas that are covered by WTO disciplines, but often expanding on them in depth and breadth, and seeking greater enforceability. The second way is through rules and disciplines spanning policies that are not covered by the WTO, or covered very imperfectly (dubbed WTO-extra). In practice PTAs often pursue both objectives but with varying degrees. North American PTAs for instance focus more on WTO-plus disciplines, adding a few WTO-extra to the mix. In contrast, European PTAs include numerous WTO extra aspects in its

agreements. Horn et al. (2009) identify no less than 38 areas in U.S. and EU PTAs that aim to go beyond WTO disciplines.

The proliferation and deepening of PTAs is creating vast opportunities to developing countries to modernize and upgrade their rules and disciplines for greater economic efficiency. It is also posing a serious challenge for policy makers, especially in low-income countries, as they must cover an increasingly large and complex set of issues with limited administrative resources – both for negotiation and implementation – and frequently no pre-existing practice.²

Indeed, PTAs increasingly address policy areas that are entirely new to developing countries. They may also deeply alter their development processes. To take an oft quoted example, it is possible that the inclusion of the most advanced forms of intellectual property rights protection may require an alternative economic development model, whereby acquisition of knowledge and know-how is no longer done through imitation and reverse engineering (such as the generic pharmaceutical industries in middle income countries), but through an as yet unproven process of capital and knowledge accumulation.

The burden of meeting deep integration commitments in new PTAs is in sharp contrast to older trade agreements, which were chiefly about dismantling barriers to trade and making trade policy simpler to administer. While multilateral trade agreements under the WTO have also pursued a similar path toward greater complexity (for instance with the agreement on TRIPS in 1995), nowhere is the policy ambition as big as in PTAs with the spreading of regulatory disciplines to non-trade areas.

Before looking at the issues in detail, it is useful to try to capture the essence of the difference in nature of the liberalization challenge posed by the new disciplines in PTAs. The trade literature usually characterizes this process in terms of positive vs. negative integration and behind the border vs. at the border integration.

1.1 Positive integration or the need for public intervention

The first Nobel prize winner in economics, Jan Tinbergen (1954) proposed the notions of positive and negative integration to characterize the process of international economic integration. Negative integration refers to the removal of trade barriers and the principle of non-

² In a WTO working paper, Fiorentino et al. (2006) note that negotiating resources are shifted away from multilateral negotiations to negotiations of PTAs.

discrimination. This is the traditional remit of trade negotiations.³ As to positive integration, Tinbergen (1954: 79) defines it as follows:

[the] creation of new institutions and their instruments or the modification of existing instruments. [...] More generally, positive integration should consist of the creation of all institutions required by the welfare optimum which have to be handled in a centralized way.

Analysts have often retained the first part of the definition, namely that integration is not just about removal of barriers to trade flows, but about “rule-making” to facilitate these flows.

Interestingly though, Tinbergen offers in the second part of the definition a vision that suggests that the creation of intergovernmental public goods is also an element of the welfare-enhancing process of integration. This is an important aspect on which we will come back later. Taken as whole, we retain from Tinbergen’s definition the basic intuition that positive integration calls for public intervention to tackle market failures that would otherwise prevent economically optimal levels of integration.

Various interpretations of the Tinbergen characterization have survived in the literature (see e.g. Pelkmans, 1986; Torrent, 2007; Ortino, 2004: 18-34; Hoekman and Kostecki, 2009). Positive and negative integration imply substantive differences in the process of integration: negative integration would be mainly about the prohibition of a narrow set of policies, joint surveillance and eventually mechanisms of redress, while positive integration requires taking active steps towards integration by defining common policies and setting up the legal and administrative framework to implement them. This difference is, however, not as clear-cut as it appears at first (see for instance Torrent, 2007 and Ortino, 2004). In both cases of integration a certain degree of legal alignment is required as is the setting up of a minimum of common institutions. For instance agreeing on new rules that limit the way governments can intervene in markets could be seen alternatively as an instance of positive or negative integration.⁴

³ The GATT architecture has been historically built essentially around the notion of negative integration and the prohibition of the most detrimental policies through elimination of border trade barriers and non-discrimination principles (Hoekman and Kostecki, 2009). Recently, however, new forms of economic integration that have been included in the multilateral trade framework starting with the Kennedy Round and services under the GATS in 1979, and continuing with the WTO (and the incorporation of TRIPS in particular). The WTO incorporates much more significant elements of positive integration than previously. PTAs follow the exact same trend, going even further in many instances.

⁴ Torrent provides the following example: “The European Community directives on the liberalization of movements of capitals seem to be a clear example of “negative” integration, but they were enacted according to what, in

Nevertheless the distinction remains useful to broadly think about important characteristics of deep integration as new dimensions of PTAs imply clearly more “retooling” of legal frameworks at the domestic level. Positive integration can be conducted in various ways depending how it is legally instrumentalized. Torrent (2007) notes for instance the substantive differences between US and EU agreements regarding procurement provisions. The US approach is more normative by inserting the rules in the agreement, whereas the EU adopts a more progressive approach by defining the rules through specialized organizations (such as expert committees). Relative to negative integration, positive integration entails substantial differences with respect to drafting language in agreements – the instruments of implementation being more complex – and therefore negotiations, as well as probably predictability with regard to implementation. For instance, when tackling trade facilitation issues, it is not sufficient to agree on rules that should be prevented (e.g. the use of consular fees), or on simple positive obligations such as transparency but countries must also agree on standards of procedures (such as for instance using risk management screening at borders) and monitor agency conduct. These obligations cannot be easily – and should not, according to some (Messerlin and Zarrouk, 2000) – incorporated into normative commitments in trade agreements. Beyond adopting new policies to open markets, positive integration is also about coordination of policies with trading partners, which may imply some form of institutional arrangements.

1.2 Behind the border policies

Another important dimension is characterized in the literature as *behind the border* vs. *at the border measures*. National Treatment and uniformization of obligations indeed differ in substance from MFN obligations in that they require that countries change policies that also affect internal transactions that are not necessarily trade related.

The question of the impact on trade of domestic regulations is not new and is for instance well recognized in the WTO: Article III of the GATT requires that internal regulations comply with the National Treatment principle. Domestic policies have the potential to be designed to discriminate against foreign producers. Beyond addressing discrimination per se – the National

Tinbergen’s terms, would be a clear example of “positive integration” (and they would be defended in this way by many in the European Commission). In political terms, NAFTA’s Chapter XI on investments would be looked at by many around the world as a typical example of “negative integration” that sharply reduces the capacity of Governments to intervene in the economy. It is also an example of “positive integration” that creates common rules that go beyond the liberalization of access (for example on protection of investments).

Treatment principle –, governments should also pursue the objective of reducing the costs of having to comply with multiple and heterogeneous requirements. As the world economy becomes more integrated and supply chains incorporate sourcing from many countries, the calls for some uniformization are growing. This is an area where PTAs play an increasing role.

With behind the border policies, domestic transactions are directly affected; this has obvious direct welfare implications that differ from the indirect effect through trade goods prices and volumes. This also means a different political economy equilibrium.

In this paper, we expand the notion of behind the border measures to include those measures that are included in trade agreements not because of their direct or indirect effects on trade, but merely because trade agreements provide a convenient vehicle of international negotiation or enforcement.

In sum, deep integration measures may concern domestic areas of policies, not necessarily directly trade related. They require more advanced reform of the legal environment and generally a more complex set of instruments for implementation. They also may involve active supra-national coordination. It is not hard to imagine then how more demanding and complex liberalization of these measures might be. The rest of this overview chapter elaborates on the theoretical and practical motivations behind today's deep PTAs (Section 2) and then highlights key areas of consideration for policy makers as they contemplate their future PTA strategy (Section 3).

2 The motivations for deep integration

The reality of the new PTA landscape raises questions about the motives for entering into regional agreements. Why would policy makers around the world invest time, political capital, and resources in negotiating trade arrangements that discriminate among trading partners with uncertain welfare benefits? The answer can only be that policymakers in those negotiations and agreements are looking for benefits beyond market access for goods and services.

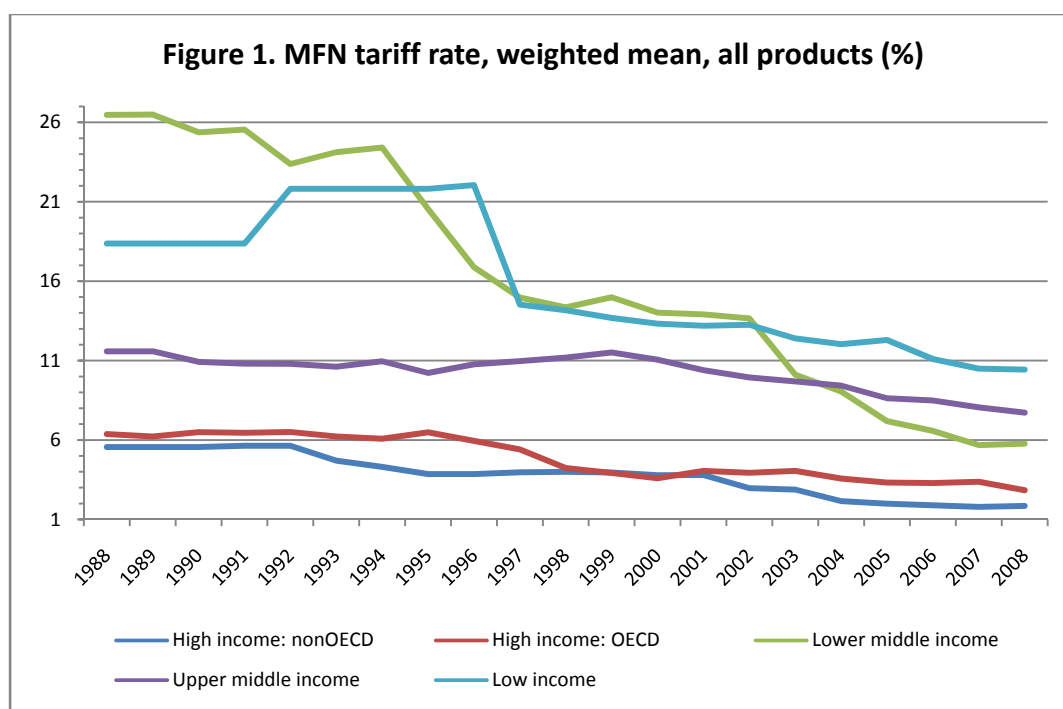
This was foreseen by Krugman (1993) who assumed that one cause of the success of PTAs was the convenience of dealing with the variety, complexity and opacity of modern trade barriers in a bilateral/regional setting rather than at the multilateral GATT/WTO level. Implied behind Krugman's statement was that the removal of traditional trade barriers was not necessarily solving the issue of market access.

Beyond the traditional theoretical explanations of economic models, other explanations, either non-standard or not well explained by the economic science, have been reviewed by Schiff and Winters (2004) who surveyed alternative rationales spanning from domestic policy anchoring, importing good regulatory practices, supra-national coordination to achieve regional policy goals, hegemony exporting regulatory standards, to foreign policy consideration. The rest of this section reviews in more detail the economic societal and political economy motives to conclude a PTA.

2.1 Economic motives

2.1.1 *Market access: A lesser driving force?*

Market access mercantilism is the traditional force behind the push for trade liberalization. Led by the false logic that import barriers should be lowered only if reciprocal access abroad for exports is granted, countries mutually agree to liberalize their market resulting in most cases in welfare enhancing liberalization. In a globalized world, countries seek to gain competitive advantage over their neighbors by negotiating special – preferential – market access with key destination markets.



Source: World Development Indicators

Several facts however challenge the traditional explanation. Preferences to start with, may not be as important as they were in the past. Tariffs have been falling worldwide (figure 1) and in a very general sense the most protected markets would now tend to exhibit tariff levels that are moderate in regard to 15 years ago.⁵ Furthermore, advanced and middle income countries exhibit on average lower levels of protection than low-income countries.

Moreover, with PTAs growing in number so do the recipients of preferences, leading to the erosion of the preference margins held over competitors. Carrère *et al.* (2010) answer the question of what is the real preference received by countries by computing an adjusted market access measure of what EU preference receiving partners actually enjoy (when one takes into account the preferences given to other partners). This measure is compared to the unadjusted measure of preference over MFN tariff and show that the real market access is often much lower, less than half in the case of Cambodia (an EBA recipient), and in some instance with no effective market access preference at all as is the case for a GSP recipient like Indonesia.

Having just noted that there is a tendency of diminishing MFN tariffs, that preferences margin are actually smaller than they appear, and finally that some developing countries already enjoy virtually tariff free access to major markets under GSP, EBA and other preferential regimes, can market access incentives alone explain reciprocal liberalization in the PTA context? In particular, as noted by Levy (2009), the reciprocal incentive seems to fail to explain the rationale behind asymmetric North-South type of agreements. Many developing countries already benefit from very good market access in their Northern partners, and therefore market access alone cannot justify North-South PTAs. Thus, at least in some cases, the rationale for PTAs goes beyond traditional market access.

Market access may remain a motive in North-North and South-South agreements. In the latter case in particular, tariffs remain fairly substantial. Other incentives may also be at play: countries at the periphery of a network of agreements (such as for instance the partners of the EU and the US) may suffer from delocalization of industries to the hub of the network and away from them (the spokes) and also erosion of their preferential access since being in the hub provides preferential access to many more markets. This reality is what has driven countries like Chile, Singapore and Mexico to pursue “spoke-spoke” strategies by mirroring their large trading

⁵ There are obviously numerous exceptions at the product level.

partners PTA strategies in pursuing agreements with the same partners (even though their trade with such distant partners might be small). One could consider the strategy of EFTA in parallel to the EU and new countries joining the EU as being driven by a similar motive as well.⁶

Bhagwati (2008) also argues that even modest margins of preference have a sizeable impact in a globalized world where overall transaction costs are decreasing and where sources of comparative advantage can be found in small cost differences (“thin” margins of comparative advantage). Thus even small preferences on paper may become attractive for prospective partners.

2.1.2 Other dimensions of market access

Market access conditions are not only determined by tariffs. First, a range of other domestic policies, such as standards, and customs procedures may affect foreign exporters’ access costs to the market. As noted by Bagwell and Staiger (2001) when governments choose these policies unilaterally, there is a possibility that market access might be set at a lower and non-optimal level than it would be under reciprocal liberalization negotiations.

Second, the market access question is not limited to goods only. Foreign investment decisions are another way to gain access in foreign markets, and therefore the inclusion of disciplines relating to investment in agreements can be an additional motive for reciprocal liberalization commitments.⁷ Many PTAs now include investment disciplines that go beyond the WTO: WTO rules are limited to the supply of services following an investment (“commercial presence”) in the GATS and to trade-related investment measures (i.e., the TRIMs agreement). Moreover, GATS relies on an “enterprise-based” definition of investment, while bilateral rules generally refer to a broader “asset-based” definition that covers portfolio investment and different forms of tangible and intangible property (Miroudot, 2010).

Third, because the traditional PTA analysis focuses on trade in goods, services trade is often omitted from the discussion. Yet, at a time when the services sector represents the largest and growing share of GDP in many developed and developing countries, when many services (e.g., electricity, telecom, transport) are key inputs into the production of goods and other services, and

⁶ See presentation by Baldwin <http://hei.unige.ch/~baldwin/PapersBooks/SpokeTrapTalk8Dec03.pdf>

⁷ According to Ethier (1998) attracting FDI is one of the main attractions of entering into PTAs (as reminded by Levy, 2009).

when the IT revolution has increased their tradability,⁸ the scope for gains from services liberalization might be considerable both in terms of increased trade flows and reduce cost inputs for firms. For some country groupings, such as South-South agreements, preferential integration in goods may bring little benefits.⁹ Exploring other integration dimensions such as services (Mattoo and Sauvé 2010), investment (Miroudot 2010) and labor mobility (Hufbauer and Stephenson 2010), where complementarities might be desirable could be a promising next step (see for instance in the case of PAFTA, Hoekman and Sekkat, 2010).

Yet the reality is that even if some limited sectoral advances have been witnessed in recent agreements (on movement of professionals for instance), PTAs have made modest inroads in terms of services market access. Regulatory policies tend to pursue non economic objectives while harboring economic concerns as well, such as the need to lower the cost of barriers and compliance. Hoekman, Mattoo and Sapir (2007) remark that this makes for a particularly complex political economy calculus: as is the case for tariffs, transaction costs imposed by deep integration policies will result in incumbent industries to resist liberalization sheltered by this protection. However, the bias against liberalization can be reinforced in the case of services by reluctance from consumers and government as well. Consumers may fear that regulatory liberalization will affect their well-being, for instance through slacker standards and lower quality of product and services.¹⁰ Likewise government and regulatory agencies may see liberalization reluctantly: first, regulation may be a source of indirect taxation, when governments benefit from rents generated by regulatory protection (this is for instance a common occurrence in the area of standards); second, governments may fear that their latitude to pursue regulatory objectives will be curtailed as cross-border supply could undermine local suppliers while being subject to different (lower) regulatory requirements; third, governments also pursue redistribution objectives for instance through universal provision requirements (water, telecommunications, postal services), and obligations to offer the poorest consumers below-cost prices (water, electricity, finance, transport).

⁸ Allowing services to be traded under several modal forms such as for instance medical diagnostics now being able to be provided by distance thanks to electronic imagery.

⁹ Small countries with similar production structures, small and inefficient manufacturing sectors might not have much to gain from engaging in goods-only PTAs.

¹⁰ Note that here well-being could be understood in broad terms as not only including economic welfare, but also value-related preferences.

Hoekman et al. (2007) further note that not only the political economy calculations become more complex in this environment, but also the usual reciprocity mechanism of trade liberalization may not work anymore because it becomes very difficult to separate clearly measures that promote market access and measures that pursue legitimate regulatory objectives.

Notwithstanding the market access considerations, PTAs have also a role to play when it comes to transnational regulation. This reflects the standard economic efficiency motive for regulation, which is to address market failures. Three oft-mentioned market failures are: 1) tackle monopoly power; 2) deal with externalities and the provision of public goods; and 3) mitigate information asymmetries.

2.1.3 Monopoly power and supranational competition

With the existence of economies of scale and more generally market failures the possibility of monopoly power and abusive conduct by private firms arises. Trade liberalization may go some way to create competition by making markets contestable, but this will not always be sufficient. As discussed above, domestic enforcement of competition rules is linked to market access. If in a national jurisdiction there is weak competition because of lack of enforcement, market concentration and collusion in domestic market may deter entry from foreign suppliers. In such instances, competition policy should complement trade liberalization in order to secure the gains from the opening of markets.

Yet, the threat of market power and abusive conduct may not be sufficient to justify the inclusion of competition rules and discipline in a PTA on economic motives alone. After all, countries can individually opt to implement competition policies unilaterally. But these may not be effective in dealing with the risk of cross-border externality and the abusive behavior of exporters abroad. Competition rules may be particularly relevant in PTAs where the risk of abuse of market power or collusive practice takes place in more than one national jurisdiction and that international legislation and cooperation is required to put an end to or sanction it. For instance, a firm may use its market power in one market to extract monopoly rents in another, a dominant position may span several countries (e.g., Microsoft) potentially leading to anticompetitive market conduct, or firms may have agreed in one jurisdiction to collude in another, therefore requiring cooperation between authorities in order to collect evidence.

Since such competition issues are trade and investment related, there are also complementarities in dealing with them in the same forum as trade arrangements. PTAs offer a scope to create disciplines that the WTO does not offer. Arguably the degree of cooperation in international competition arrangements will depend on individual economies sizes, the level of trade, and also the extent of their enforcement capacity.

2.1.4 Externalities and public goods

An externality (or transaction spillover) is a cost or benefit, not transmitted through prices, incurred by a party who did not participate in the action causing the cost or benefit. Externalities are not necessarily confined within the borders of a given countries (climate change for instance or depletion of fish stocks), and in some cases may be best tackled by a small group of countries. For instance river management should involve neighboring countries, as do some transport issues. Externalities are closely related to the need to provide public goods, i.e. goods that are non-rivalrous and non-excludable.¹¹ Markets may fail to spontaneously provide goods that are socially desirable (such as clean air) in the presence of externalities.

Addressing regional externalities should logically be a priority of regional PTAs given the need for some form of supranational coordination to help internalize the externalities. Coordination can take several forms:

1. Alignment (for instance through mutual recognition agreements) and/or harmonization of policies to eliminate segmentation of markets and duplication of the costs generated by barriers at the border.
2. Alignment and harmonization of policies to avoid “leakage”. This is for instance when one jurisdiction in the PTA has lower regulatory standards, thus possibly undermining regulatory efforts of its trading partners. One example is deficient control of animal epizooties or pests in one country that spill over neighbors as animal border crossings cannot be totally controlled.
3. Alignment and harmonization of policies to create networks and facilitate information exchange. This essentially relates to the adoption of common standards and regulatory

¹¹ In economics, non-rivalry means that consumption of the good by one individual does not reduce availability of the good for consumption by others; and non-excludability that no one can be effectively excluded from using the good.

language in order to facilitate flows within the region (for instance ensuring interoperability of national networks at a regional level). Sectors where this seems of particular relevance are services sectors such as financial and insurance, IT, professional services, transport and electricity.

4. Pulling of efforts to create infrastructure, or of resources (financial, human) to provide a regional public good. Large infrastructure serving a region such as a hydroelectric dam or a large port are examples where pooled financing might be needed.
5. Joint decision making to ensure that national policies are coordinated at the regional level (e.g. management of food stocks).
6. Transfer of resources to solve externality problems when the contribution of individual member states is required. A common instance is when institutions are weak and capacity building is required to bring a partner country to a higher standard for the regional common good (e.g. customs enforcement).

Regional externalities should arguably be dealt over the jurisdiction over which they occur; therefore they require transnational mechanisms of cooperation. However, it is not entirely clear whether regional externalities (positive or negative) should necessarily be addressed in the specific context of a PTA. There is always the possibility (as for all commitments agreed in PTAs) to address these issues through dedicated agreements and transnational institutions such as bilateral customs or water management agreements for instance. Historically, many of these problems have been addressed this way.

2.1.5 Information asymmetries

Product characteristics are often not discernible to buyers before consumption. Such goods are called experience and credence goods. While experience goods reveal their characteristics upon consumption (e.g. the quality of a product cannot be observed before), credence goods do not (e.g. chemicals may be harmful to health, unbeknownst to people exposed to them). Information asymmetries may also affect producers themselves when consumers' characteristics are hidden (e.g. the problem of insurance). While in most instances the market itself tackles these information asymmetries through information and brand signaling, when the asymmetries are not addressed the market outcome is suboptimal. The problem of information is particularly acute for

services due to their intangibility, which makes harder for the buyer to learn about quality prior to consumption (Hoekman, Mattoo and Sapir, 2007).

Regulation may then be called for, for instance through licensing or imposing compulsory standards. International cooperation may thus help reduce the overall complexity of the regulatory framework for international traders by aligning and harmonizing regulations. It may also be the case that failing to tackle some of these issues in a coordinated fashion may generate negative externality effects.

In the specific PTA context the test will then be to assess whether information asymmetry problems are best tackled at the bilateral or plurilateral level, rather than in other international forums. In most instances, this will be a question of judging the tradeoffs between the transaction costs of cooperating with a given number of countries (or the international community) and the benefits of coordination at the global or PTA level. Taking the example of regional standards, there is a clear risk that standards may exclude third non adhering countries. However, it may be much easier to agree on a common approach with a small number of countries and with countries with similar preferences. Finally, in some cases (e.g. regional epizooties) a country-group approach will be the needed one.

2.2 Societal motives

Beyond the economic motives, a PTA can be motivated by a number of societal motives or value-related demands as Bhagwati (2008) calls them. Each society has moral and social preferences that may be undermined by market forces if left to their own devices. For instance the trading of dangerous weapons or morally/religiously reprehensible material may need to be restricted. What is considered dangerous or morally reprehensible will vary significantly for each country and culture.

Social norms and values may be undermined by trade liberalization: after all it is still easier to control borders than a whole territory, and foreign producers may not hold themselves up to the same standards as the nationally chosen ones. This has long been recognized in multilateral trade agreements with the possibility of safeguard provisions and general exceptions (on moral grounds for instance). At the same time, the mechanisms of safeguard and the language of general exceptions may be found to be insufficient and therefore countries may want to negotiate

sector specific provisions in PTAs, such as for instance reservations in the opening of services sectors to meet universal provision.

At the opposite of using trade agreements as safeguards, they also serve as vehicles to further societal objectives too. Development policy concerns, for example, are increasingly present in agreements, such as in the EU sponsored EPAs. Another instance of issue pushed by Northern partners relates to good governance, democracy, labor rights and human rights (Elliot 2010; Aaronson, 2010).

What is then the specific value added of PTAs in helping achieve these objectives? A first motivation might be that the threat to societal preferences is localized in a limited number of partners and thus it makes more sense to deal with them directly. Narcotics production is one instance and explains why some PTAs have been specifically linked to measures to fight against production and trafficking such as CAFTA in the US (Hornbeck, 2003).

PTAs might be seen as the locus of positive spillovers between trade and these policy issues. For instance, provisions on governance – open and transparent procedures – for international flows arising from the trade agreement would spill over in other domestic areas.¹² Clearly, in the case of trade and development, there are complementarities between openness and poverty alleviating growth and again PTAs help target specific countries. In other instances, and more prosaically, this might be merely the outcome of a *quid pro quo* between market access in the North and concessions on other fronts in the South.

A second motivation relates to the choice of the best available forum (see also section 2.3.2 below) for promoting the international sharing of such values, either focusing on issues that are not already present in other agreements such as the WTO (for instance on labor rights or environment protection) or pushing for higher standards than currently existing in the international community. This is for instance a clear objective of the US new trade policy of pursuing PTAs that was initiated under the Bush administration. In a 2001 speech then-Ambassador Robert Zoellick said: “... we need to align the global trading system with our values. [...] We can encourage respect for core labor standards, environmental protection, and good

¹² According to Levy (2009), several mechanisms could be at play: once a bureaucracy commits to good governance, it may make little sense to maintain a different attitude for the domestic market; good governance for international flows could serve as a signal spurring reform on the domestic front; there might be costly and adverse reputational spillovers if the rule of law is not followed in the country that may affect the decision of foreign investors and traders.

health [...] And we must always seek to strengthen freedom, democracy and the rule of law”.¹³

Related to this is the desire to use every trade forum to reaffirm these choices with a view of mutual complementarity and reinforcement between these different instruments.

2.3 Political economy motives

Beyond the need for coordinated policy making with trading partners, PTAs also serve as forums for policy objectives that are neither strictly related to exchanges nor to the preferential nature of PTAs. PTAs can be seen as efficient fora to achieve broader geopolitical, institutional, and policy anchoring objectives.

2.3.1 *Geopolitical*

Geostrategic considerations have historically commanded the formation of PTAs. There are numerous examples of trade agreements that have been used to promote peace. Chief among them is the European Union, which was borne from the desire to prevent war again in Europe. Winston Churchill called in 1946 for a “United States of Europe,” but it is through economic integration and the 1951 European Steel and Coal Community that European integration duly started (Winters, 1997; Baldwin, 2008).¹⁴ Others examples of agreements used for stability purposes include Mercosur, and APEC (Bergsten, 1996). More recently, the push by the USA to conclude PTA has also been motivated by foreign policy motives (Bhagwati, 2008; Evenett and Meier, 2008), as is Europe’s neighborhood policy (European Commission, 2007).¹⁵

Thus PTAs can contribute to deliver peace and stability as a regional public good (Winters and Schiff, 2004; and box 2.6 in World Bank, 2005). Two mechanisms may come into play. First trade exchanges increase economic interdependency and thus act as a disincentive for conflict.¹⁶ They also may contribute to increase familiarity and trust and help diffuse trade related disputes.

¹³ As quoted by Evenett and Meier (2008).

¹⁴ The choice of Coal and Steel was not only on the premise of the economic importance of the two sectors, but also because these were considered to be the main inputs to making weapons: “The pooling of coal and steel production should immediately provide for the setting up of common foundations for economic development as a first step in the federation of Europe, and will change the destinies of those regions which have long been devoted to the manufacture of munitions of war, of which they have been the most constant victims”. Robert Schuman, Declaration of 9 May 1950.

¹⁵ “The EU can make an important contribution by working around the conflict issues, promoting similar reforms on both sides of the boundary lines, to foster convergence between political, economic and legal systems, enabling greater social inclusion and contributing to confidence building”.

¹⁶ World Bank (2005) notes that some wars started out partly as trade disputes such as the U.S. Civil War (1861-65) and the Soccer War (1969) between El Salvador and Honduras.

Second and more specific to PTAs, institutions themselves serve as a conduit for diplomacy, allowing for frequent and repeated officials interaction, and better exchange of information (Haftel, 2007). Deep PTAs seem more attractive in this respect since they exhibit more sophisticated institutions.

Empirically, Mansfield and Pevehouse (2003) found that membership in a PTA significantly decreases the likelihood of armed conflict. More recently, Lee and Pyun (2009) provide statistically significant evidence that PTA institutions decrease the probability of conflict between members. WTO membership on the other hand seems only marginally significant. Mayer et al. (2010) test the interaction between conflict and PTAs over the period 1950-2000 and find that the hypothesis of geopolitical motivations behind the agreements is supported by evidence. Yet for PTAs to help ease the probability of conflict there must be the scope of sufficiently large trade gains between the partners: economics and political motives thus complement each other.

2.3.2 *Institutions for reform*

By offering a different set of institutions, and related services than other forms of international agreements, PTAs provide an infrastructure for institutional dialogue and cooperation. As noted by the World Bank (2005), many issues covered by PTAs (such as the externality problems described above) could well be handled without a trade agreement, but if they are this must be because PTAs are perceived to offer a good framework to make progress.

PTAs are relatively flexible instruments in so far as they allow for various levels of legal commitments and nearly infinite ways of creating policy space. Taking the specific case of dispute settlement, the options are numerous: no mechanism at all, or one or several dispute settlement mechanisms. Each PTA can come with its own *ad hoc* mechanisms, including sector specific mechanisms or referring to external mechanisms such as international arbitration or WTO dispute settlement. Before dispute settlement *per se*, various ways of reaching settlement are provided from good offices, to third party mediation, and conciliation. Indirect evidence of legal flexibility is also provided by Horn et al. (2009) who show that binding and non-binding provisions coexist in agreements in nearly all issues covered. Note that such flexibility might appear as a virtue to policy makers but may not be necessarily so in terms of achieving factual reform.

Innovative institutions are also a feature of many PTAs, not found in particular in the multilateral forums. Involvement of the private sector is one of them, from involvement in stakeholder forums to the ability for private parties to lodge complaints as with the European Court of Justice, the General Secretariat of the Andean Community or the NAFTA investment provisions (Porges, 2010). Some PTAs also offer more substantial transfers of sovereignty. Governments can also opt to devolve some of their authority to institutions created by PTAs such as regional competition authorities, as described by Dawar and Holmes (2010).

Transaction costs of agreeing are lower in PTAs where the number of participating countries is low. It also makes free riding more difficult, a key obstacle to successful global liberalization (Krugman, 1993). Lower transaction costs, both allow for more binding constraints each partner (non cooperation is more difficult), as well as also allowing for further legal flexibility with the possibility to amend, and revisit PTAs more frequently than multilateral agreements (as the numbers required to reach consensus is lower). Smaller number of participant countries enables more frequent and probably less formal interactions, which can contribute to problem solving and deeper interactions. This seems an important feature for regulatory dimensions, which require agreeing on complex issues (such as mutual recognition agreements) and the setting up of expert bodies. This is the road followed by the European Union under the Florence process.

Resource transfers are more likely to occur in the framework of PTAs than in other international agreement settings. It is a fact that many PTAs, North-South in particular, incorporate such transfers. Agreements signed by the EU are the most striking examples, but other examples include US FTAs with Latin American partners, and South-South agreements like COMESA. Resource transfers matter in particular for deep and asymmetric PTAs. Arguably deep integration creates heavier demand on capacity. Less developed trade partners may not have the capacity to meet the regulatory standards of their partners and thus grant them effective market access, compensate for some of the adjustment costs of reform, contribute effectively to the production of regional public goods, and even more broadly when transfers help them meet some of the geopolitical and societal objectives mentioned earlier (development, conflict prevention, etc.).

2.3.3 *Policy anchoring*

A traditional political economy explanation for binding international trade commitments is the pursuit of a domestic reform agenda and the use of external commitments to “lock-in” the progress and prevent future reversals. The opportunity of lock-in is also a motive for including behind the border aspects in agreements. PTAs may be perceived as more effective lock-in mechanisms than other international agreements. PTAs would also complement other instruments in the process of external lock-in of reforms.

By extending their reach to regulatory issues PTAs offer a way to improve policy credibility (Hoekman 2010). What are the differences then between the sort of anchor offered by PTAs and the one provided by the WTO? Aside from the obvious point that PTAs may offer commitments in WTO-plus and WTO-extra areas, other aspects may point to specific advantages offered by them. The possibility of picking a partner may help reinforce the credibility aspect, as the partner of choice may be perceived as a strong proponent of reform. Indeed, the EU, the US and other developed countries promote various agendas through their respective PTAs. Picking a partner or a group of partners may also signal a preference for a certain regulatory approach. Additionally, lock-in by the means of PTAs can be complemented by transfers of finance and knowledge.

Another argument, put forward by Schiff and Winters (1998) is that PTAs may actually be better suited for locking-in policies because enforcement threats are more credible there. Incentives to enforce commitments are higher in a PTA because it limits the possibility of free riding and coordination problems that may arise in multilateral forums. Also, there is more scope for retaliation as concessions may go beyond just tariffs in a PTA. Schiff and Winters however note that the disciplining effect is only limited to the extent of partner countries in the PTA, not third country members.¹⁷ These dynamics are echoed by the conclusion reached by Prusa (2010) that PTAs tend to discipline the use of contingent protection measures among partners, while at the same time there seems to be an increase of the use of protection against third countries.

There are several recent examples of countries that have used PTAs to pursue an ambitious domestic agenda. Schott (2003) refers to Mexico and Chile. Likewise, Eastern European countries accession to the EU was strongly motivated by the desire to irrevocably break with socialism and consolidate their market economy reforms. More recently, Costa Rica and Peru

¹⁷ They refer to the peso crisis of 1994-95 when Mexico raised its tariffs on 500 items on *non-NAFTA* suppliers.

used their FTA negotiations with the US to push domestic reforms. Levy (2009) reviews the motivations behind the US-Peru FTA and cannot really see much market access motives for Peru, save for securing greater certainty about future access (trading temporary preferences for more permanent ones). In contrast, the agreements helped Peru cement its economic policy reforms. Some were part of the FTA implementation program, notably in the areas of services and investment, but the agreement also helped lock-in prior policy reforms (such as tariff reductions). Levy (2009) also sees among the Peruvian motivations to sign the FTA with the US the hope that it would generate broader positive spillover effects on Peru's governance and rule of law. By imposing good disciplines to protect foreign investors and market access, the FTA would signal a commitment to a better legal environment more broadly.

In sum, it would appear that there are strong rationales for policy makers to embark into deep and comprehensive PTAs but the relative merits of regional integration are also issue and country specific. The choice to include regulatory aspects in PTAs is essentially dictated by a dual concern: market access and addressing market failures, national (through lock-in effect of policy reform and policy upgrading) and regional (through tackling of cross-border market failures). Market failures will be of different nature and involve different set of countries depending on the sector and issue at hand, hence the need, as for any regulation to take a case-by-case approach. Other non-economic factors such as fostering societal choices may also apply for some issues of regulatory nature. Finally, specific institutional characteristics and advantages may also motivate the choice of PTAs as adequate forums for reform.

3 Deep PTAs are different

While creating opportunities, the increased scope and depth of PTAs pose extra challenges to policy makers as they tread the complex market access and regulatory web of PTAs. Deep integration PTAs may require policy makers to re-evaluate their approach when negotiating and implementing PTAs. In particular, to what extent are the multiple motives pursued by PTAs consistent and congruent? Do new disciplines incorporated in PTAs create a different category of obligations? Does the deepening and popularity of PTAs create new challenges to the multilateral trading system? In this section we suggest four major areas of focus for policy makers, especially in developing countries, as they refine their regional trade strategies: (1) to

reexamine the question of discrimination and preferential access; (2) to favor a holistic approach; (3) to build in flexibility; and (4) to focus on implementation.

3.1 It's not so much about preferences

Are the traditional concerns of discriminatory liberalization valid for the new areas of deep commitments in PTAs? Do deep integration measures generate trade diversion? Can it harm the liberalization country? Do they act as stumbling blocks to further liberalization? These issues, in particular those relating to the impact of deep integration on multilateral architecture have generated sizeable interest of late (OECD, 2003; Baldwin et al., 2009; Estevadeordal et al., 2009), thanks to mounting evidence provided by new PTAs. The three classical economic concepts to analyze market access discrimination in PTAs (i.e., trade diversion, third party effects, and systemic effects) are applied below to the new regulatory commitments found in today's PTAs.

3.1.1 *Trade diversion matters less*

Discrimination in deep integration agreements can secure the benefits of market access without generating the potential cost of trade diversion.¹⁸ In this sense regulatory discrimination does not raise the same concerns as tariff discrimination would. Taking together the certitude that better market access will be beneficial, and that no diversion costs will occur, leads to an important consideration for policy makers. All things equal PTA partners will unambiguously gain in preferential deep integration efforts. This may explain why deep integration issues are gaining popularity in PTAs.

Protection afforded by lack of regulatory openness is not necessarily protectionist in intent. Regulatory requirements often impose a transaction cost on the exporter without corresponding rents for the home country.¹⁹ No rent is created, just an inefficiency loss. A case in point is superfluous or antiquated border controls, which create additional costs without any corresponding benefits.²⁰

¹⁸ This point is made by Fink and Mattoo (2002) and Evenett et al. (2008).

¹⁹ Thus it does not necessarily generate positive terms of trade effects for the home country (the customs duties revenue in the case of tariff protection).

²⁰ In most cases the situation is not that clear cut. Regulatory burden often creates additional jobs for administrations and also provides opportunity for graft or for indirect taxation.

In such instances, liberalization of services, standards, trade facilitation, investment liberalization and openness of government procurement can generate benefits even if done on a preferential basis. It is however important to stress that this positive effect only occurs under the condition of no rent transfer from domestic to foreign producers.²¹ In services trade, for instance, the impact of preferential liberalization will vary depending on the nature of the regulatory barriers present. If lack of competition is an issue, regulatory liberalization may well substitute a domestic monopolist practice with a foreign one (Mattoo and Sauv , 2010). Likewise where services market access is subject to some form of licensing, rents may arise and so the cost of trade diversion. In the case of government procurement, there is an additional aspect at work. Restrictive and discriminatory government procurement rules do not affect the market as a whole and therefore exclude suppliers only from serving the public share of the domestic demand (Dawar and Evenett, 2010). Depending on the size of public markets, this may not be enough to exclude foreign suppliers from the market altogether.

3.1.2 What about the impact on third parties?

Turning now to the impact on third parties, the standard effect of discrimination will still be harmful for excluded countries. This is for instance the case when countries adopt European standards instead of international ones (Maur and Shepherd, 2010). However, it is important to ask whether preferential measures are always discriminatory.

An important characteristic of regulatory measures is that *de jure* preferential treatment might be difficult to apply and therefore *de facto* MFN liberalization is a preferable option. This is because devising a new regulatory regime applicable for each PTA may be impracticable or more simply because the concept of rules of origin that applies to product characteristics cannot as easily apply to regulations or intangible transactions.²² For instance, provisions on intellectual property rights protection apply equally to all origins, including domestic ones. Carving out specific regimes for some countries (as in the case of the article 6 exception for LDCs in the WTO agreement) requires complex legal and practical arrangements. Similarly for customs procedures, while trade rules may differ depending on the origin of product, it makes sense to keep as much

²¹ And therefore no prior rent capture by domestic interests since the objective of regulatory controls is not to raise revenue or afford protection.

²² The distinction is often blurred and when identification methods are imperfect, origin is often used as a very imperfect proxy for other characteristics (as is country of citizenship for migrants).

as possible similar procedures regardless of the origin of the good because most objectives of border controls apply to all imports. Those examples show that the concern of negative impact on excluded parties can largely disappear in the case of deep commitment provisions and that, instead, preferential liberalization could generate positive externalities on third countries.²³

This is however not a universal rule. A characteristic of deep integration liberalization is that there are instances when discrimination is inevitable and even necessary. The main illustration of this conclusion is provided by mutual recognition agreements (MRAs). MRAs can be negotiated in any regulatory area and are basically a way to lower barriers to entry into the domestic market for foreign producers without outright harmonization of rules, and thus enabling to preserve regulatory diversity and allowing countries to maintain national objectives and preferences. By this principle, parties agree in essence to keep their own regulatory ways, provided that they both meet minimum common objectives. Recognition can be agreed both for regulatory standards and the testing of these standards, and in several areas: services (e.g. professional standards, transport), trade facilitation (e.g. declarations made with foreign customs), and of course technical barriers to trade and phytosanitary measures. Another instance when discrimination is needed relates to customs controls. Modern and efficient risk-based border management calls for the selective control of imports to focus on categories that present the highest risk of non-compliance. Risk criteria discriminate for instance by product category, country of origin and identity of shipper (such as in the case of simplified controls for authorized economic operators and express shippers).

Finally, the fact that liberalization in preferential settings could de-facto lead to MFN liberalization has profound implications in terms of overall liberalization negotiating strategy. Concessions given to one partner cannot be again offered again to another, when they are non-discriminatory and implicitly offered to the rest of the world. One implication might be that such liberalization is harder to obtain because more likely to be resisted by domestic firms that would not only lose to the preferential partners as would be usually the case in a trade diverting PTA, but to the world as a whole (Krishna, 1998). This also undermines the reciprocity rationale for signing North-South agreements, as negotiating market access preferences for goods (the objective of the South) against deep regulatory commitments (the objective of the North) seems

²³ This claim was for instance tested empirically by Czubala et al., 2009 in the context of adoption of international standards.

to make little sense for developing countries. Preferences are bound to be eroded over time, whereas regulatory commitments are both permanent and MFN. Alternatively, as argued by Limão (2007) this asymmetry could provide also an incentive for PTAs to maintain high barriers against third countries (high preferences) to provide greater incentives for cooperation in non-trade areas and make the threat of preference erosion a more distant reality.

Another related consideration is that there could be a premium for parties that want to export a certain regulatory model, more advantageous to their own firms, to be the first to negotiate with a given country. This may be one aspect of the competitive liberalization framework described by Bergsten (1996).

3.1.3 Deep integration as a building block

Are deep commitments in PTAs building or stumbling blocks to multilateral liberalization? This is a legitimate question, given that the slew of new commitments in PTAs makes these agreements much more complex and by adding new dimensions, may create even more hurdles toward the welfare superior objective of multilateral liberalization. Even considering the more traditional aspect of tariff preferential liberalization, the answer to this question is not entirely clear, with some arguing that PTAs fundamentally undermine the multilateral system (the “termites” of Bhagwati), and others seeing in PTAs a component of an overall dynamic of liberalization (Baldwin and Freund, 2010).

In the context of deep integration, similar concerns prevail. How do complex and largely *ad hoc* PTAs touching on services and behind the border measures interplay with the multilateral order? Part of the answer was provided in the previous section, when the point was made that liberalization is often MFN in nature, thereby removing concerns about stumbling block effects in these instances. There is also more to this story, as discussed by Baldwin, Evenett and Low (2009), and in OECD (2003). Several mechanisms supporting a further liberalization are actually found in PTA provisions.

- A first instance is when adherence to international standards is advocated in PTAs, such as for sanitary and phyto-sanitary measures and technical barriers to trade (Lesser, 2007). Numerous also are the PTAs that refer directly to WTO rules.

- A second mechanism at play is that of “third-party,” “non-party” MFN clauses. Such clauses are often found in services provisions (Fink and Molinuevo, 2007), and in government procurement (Baldwin et al., 2009). According to third-party MFN rules, *future and more advantageous* commitments with other partners should be granted to PTA partners as well thus triggering automatic liberalization. As noted by Baldwin et al. (2009), a benefit of such rules is to avail small countries from the bargaining power of more powerful countries with common trade partner and benefit from increased market access this way.
- A third mechanism is when regimes operate under liberal rules of origin (ROO) (or liberal “denial of benefits” provisions). ROOs do not only occur for preferential trade in goods, but in any instance requiring establishing the origin of the partner subject to preferential rules. This includes various instances in PTAs, such as access by third parties to MRAs, ROOs applying to foreign firms establishing local presence (mode 3) in the partner country (Mattoo and Sauvé, 2010), or government procurement (Dawar and Evenett, 2010).²⁴ Rules of origin applying to regulations happen often to be liberal, because it either becomes complex to operate them or because as we saw earlier it does not make sense to operate parallel regulatory systems instead of an MFN one.
- A fourth phenomenon at play is the diffusion of identical and liberalizing rules in PTAs. This is a phenomenon that has been in particular noted in “contiguous” PTAs having one partner in common. This is what for instance happens in investment provisions in agreements in North and South America, in procurement provisions, and in contingent protection (Baldwin et al., 2009). This however, could have a downside as large trading powers export their own – and not necessarily compatible – vision of a liberalization agenda. Prusa (2010) describes also a phenomenon of rules diffusion with the EU and US acting as spokes in their respective networks. More broadly, template approaches to liberalization are often used in PTAs. Rules relating to investment, services liberalization or standards tend to replicate one of two or three existing models.

²⁴ Baldwin et al. (2009) give the example of rules of origin in East Asian PTAs as particularly liberal since they only require incorporation under the laws of the trade partner and do not impose any other nationality requirements on the entity such as nationality of people controlling the firm.

In sum, discrimination on the implementation of deep commitments in PTAs should not be underestimated but there are also ways to deal with it. It should not be underestimated because deep integration creates stealthier and more complex ways to discriminate. Trade partners can push for specific regimes designs aimed at carving out more favorable market access conditions. One example is the insistence by the United States to include customs rules in its FTAs that allow for a preferential treatment for express carriers.²⁵ However, the parallel with the tariff analysis of preferential liberalization does not necessarily hold: the risk of trade diversion is less a concern. This impacts the welfare implications of preferential liberalization which are then necessarily positive. Thus PTAs would in such cases contribute to overall welfare gain. Moreover the rather complex nature of regulation tends to work to the advantage of MFN liberalization as it is often too complicated to manage multiple regulatory regimes to create specific preferences.

3.2 It's about policy complementarities

The expansion of PTAs into new disciplines implies that policy makers are confronted with multiple policy choices with different objectives and complex interactions. In essence new PTAs capture a broader paradigm than traditional ones. Evans et al. (2006) characterize one aspect of this expanded paradigm by pointing out that unlike traditional trade liberalization that focuses chiefly on goods trade, deep integration aims at broad factor mobility, including investment (capital movement) liberalization, services, migration and labor standards dimensions (labor movement). Perhaps nowhere more than in PTAs are all the liberalization dimensions explored as deeply and comprehensively. The complementarities thus created might then explain the attraction of PTAs (Mattoo and Sauv , 2010). A good example is the trade facilitation agenda, which requires the streamlining of numerous border measures, all have specific regulatory objectives in many sectors (health, immigration, security controls for instance), the inclusion of services sectors that facilitate trade (transport, logistics, insurance, etc.), the consideration of movement of persons, standards policies, etc.

The other aspect of the broader agenda is of course the regulatory one and the inclusion of domestic and other policies whose objective is not protection but to remedy some sort of market failure. The reason why such policies are included in PTAs is at least in part because trade

²⁵ This is an industry where the US is well represented.

liberalization interacts with the objectives pursued under these policies in ways that may often be seen as making these objectives more difficult to achieve. Thus trade policies cannot be conceived anymore by assuming separability from other policies.²⁶

Deep integration is as much about trade as it is about other dimensions of economic management and public policy. Starting with liberalization of services, all the deep integration policies meet specific objectives: the liberalization question cannot be divorced from the consideration of these objectives. Thus policy makers should carefully think about *why* and *how* trade agreements should serve these objectives in the specific context of PTAs. The table below offers a snapshot of their variety.

Area	Regulatory objectives
Services	Universal provision (access, prices) Standards (professional, safety, interconnection) Prudential regulations (banking) Cultural exception (media)
Goods Standards	Human, plant and animals Health Safety Network economies
IPRs	Innovation & Creativity
Trade facilitation	Fiscal revenue Border security Prohibitions Immigration control Enforcement of domestic laws on foreign goods Transit
Government Procurement	Buy national provisions Sensitive sectors protection (defense)
Consumer law	Consumer information and protection
Labor & Human rights	Minimum standards
Environment	Public goods Minimum standards
Movement of persons	Immigration management

Source: Authors

In his book *Termites in the Trading System* (2008), Bhagwati pointedly mocks the notion of trade-related policies: “If I sneeze and use imported cough syrup, that immediately affects imports; if I use domestic cough syrup that potentially reduces exports of the syrup I have used

²⁶ While this was never really the case in practice, the traditional approach to trade policy was to consider it in relative isolation of other policies (including other economic policies).

up”. It is true that by pushing the logic *ad absurdum* every issue becomes trade-related and has a trade effect. While this does not mean that the impact of policies on trade (and vice-versa) should be ignored, it is important to make a distinction about the primary objectives of policies and how to achieve them. The question therefore, for regulatory issues, which are in essence behind-the-border and not unique or specific to traded goods, is of three orders:

1. What are the issues of true international dimension that can *only* be addressed through international agreements?
2. How should behind-the-border rules in PTAs be designed to minimize trade distortionary effects?
3. How should policy makers prepare themselves to negotiate or resist such rules?

The first two questions roughly ask: what is the actual link with trade issues? On the first question, as seen earlier, market failures and externalities of supranational nature could be addressed using PTAs. For instance in the case of trade facilitation, international transit is clearly of regional dimension. Arguably, these issues can also be addressed in separate dedicated agreements, such as bilateral cooperation treaties for competition law or standalone transit agreements (see Dawar and Holmes, 2010; Maur, 2008). International trade may also be an important source of market failure, for instance on environment protection (Anuradha, 2010).²⁷ Because of the binding nature of international agreements and the international trade dimension of externalities and market failures, there is a space for regulatory frameworks in the context of PTAs. Issues that were previously dealt under dedicated bilateral instruments, such as Bilateral Investment Treaties, Customs Cooperation Agreements, and Competition policy cooperation, are now increasingly incorporated into PTAs. Although the jury is still out as to the most effective instrument in terms of implementation, PTAs may be superior instruments in two respects: the possibility of issues-linkages, and institution-savings costs since one body serves several purposes (Devlin and Estevadeordal, 2006).

On the second question of reducing distortionary effects, the approach should be to minimize the conflicts of objectives between regulatory and trade liberalization objectives. For instance, harmonization to low standards level would maximize trade liberalization objectives, but clearly

²⁷ Environmental externalities could also be the result of purely domestic economic activities.

not meet regulatory objectives (countries may have different objectives, and low standards may not meet their preferred level of enforcement). An obvious approach is to ensure that clarity of regulatory objectives is such that any protectionist intent cannot hide themselves behind the disguise of rules. Hidden protectionism operates by raising the costs of (foreign) rivals, which can be achieved both by discriminatory rules at home (e.g. standards designed in such a way as to exclude foreign products) or raising standards abroad (e.g. by exporting new regulatory requirements that increase the cost of production there and shift comparative advantage patterns).

On the question of negotiating or resisting such rules, a first step is to clarify the policy making process involved in taking future commitments, starting by involving key ministries and administrations overseeing the non-trade objectives and ensure mutual understanding and coherence of objectives. Historically, PTA negotiations have typically been led by the finance, foreign affairs or trade ministry. These ministries would seldom coordinate with other ministries or specialized bodies of government, and sometimes with limited understanding of issues at stake. A second set of measures is to minimize the costs of meeting the regulatory objectives with reasonable *statistical confidence*. This is often not done, as instead solutions that meet the objective of regulation irrespective of the costs caused by trade distortions are chosen. The notion of risk is often not embedded in the regulatory design since agencies have no direct interest in considering the costs borne by other parts of the economy in meeting their objective, and will naturally opt for regulatory solutions that minimize risk rather than costs. An example is border controls, where 100% checking of consignments is not rare, at the expense of economically efficient methods of solely targeting risky shipments. Thus the marginal costs of meeting regulatory objectives (in particular the costs on trade) should be balanced with the marginal expected benefits.²⁸

Another important aspect that may justify resisting the incorporation of regulatory objectives in PTAs is the importance of national endowment and preferences, which will differ across countries. Bhagwati (2008) suggests that the rationales for different labor standards apply for countries that are at different stages of development and with different economic contexts. While harmonization eliminates the costs associated with duplication and complexity, it can undermine national objectives by departing too much from them, and also in the case of upward

²⁸ See also Shepherd and Maur (2010) for a discussion of this in the context of standards.

harmonization to stricter regulatory levels actually raise the costs faced by some countries. These countries are often the poorest ones. The exportation of (higher) regulatory standards and practices has been flagged in the recent literature as integral to the strategy of the two biggest proponents of PTAs: the US and Europe (Horn et al., 2009; Bhagwati, 2008; Maur, 2005). A closer examination of PTA disciplines indeed suggests that template approaches to PTA liberalization are indeed promoted by both hubs. This is worth highlighting as the EU and US approaches generally differ quite substantially. The influence of the EU and US hubs is for instance noted for contingent protection rules (Prusa, 2010), the use of mutual recognition versus equivalence for standards (Maur and Shepherd, 2010), different areas of focus for IPR protection (Fink, 2010), or the diffusion of procurement and investment rules (Miroudot, 2010; Dawar and Evenett, 2010). PTAs (and bilateral agreements in general) offer a solution to deal with heterogeneity of preferences through the principle of equivalence, which often takes the form of mutual recognition, which we discussed earlier.

3.3 It's about flexibility and customized problem solving

The flexibility offered by PTAs in terms of tailoring the level of ambition of given disciplines according to the trading partners is one conclusion arising from the early work looking at the new wave of PTAs (Heydon, 2003). While special and differential treatment and policy space are an important feature of modern trade negotiations involving developing countries, we take here the logic further, arguing that it is not only the nature of partner countries and their capacity that dictates the need for such flexibility, but the regulatory issues themselves.

Many of the new policies captured in the latest generation of PTAs do not lend themselves to be reduced to standalone legal language in a trade agreement. Rather, deep integration requires flexibility and customization in the way provisions are drafted:

- Provisions in the agreement are only one of the blocks of broader cooperation that may include institutional arrangements, hard (e.g. a common institution) or soft (e.g. expert consultations), as well as technical assistance and capacity building;
- Gradual implementation as reform may not be carried overnight and will present unique challenges in a given country context;

- In particular joint projects such as harmonization work, setting up common regional tools, etc.;
- Need to revisit areas of cooperation as regulatory needs change over time;
- Need to revisit deep integration areas as understanding of how best to address regulatory dimensions evolve over time;
- Need to monitor implementation of policy;
- Need to recourse to other venues than dispute settlement;

Reliance on a rigid interpretation of an international agreement and enforceable through dispute settlement is insufficient for deep integration dimensions of liberalization (Hoekman, 2010).

Deep integration requires a combination of hard and soft law and capacity. The reasons for this are a) practicalities, b) uncertainty, and c) political economy. The appropriate implementation of behind the border policies requires a set of actions ranging from legal provisions, to establishment of adequate structures, including not only appropriate governance and rules, but also material and personnel to operationalize these policies, as well as reporting mechanisms. All this is highly complex and difficult to specify in full in an international agreement and may as well be dependent on the specificity of domestic structures. The second problem arises from the fact that there is uncertainty about what is the most appropriate design for regulatory policies and their outcomes, since this probably depend on countries circumstances. A good example of this is the variety of competition provision rules and set up in PTAs (Dawar and Holmes 2010). Inter alia, configurations on common competition regimes and provisions are largely influenced by national regimes, the size and level of development of partners. Another source of uncertainty is time, when technological changes for instance may affect fundamentally the nature of goods and services exchanged, how markets, market operators and government bodies conduct their work (as in telecom services, standard policies or border controls). Finally, the political economy of PTAs relying on soft law mechanisms might be more supportive of actual liberalization than a top-down approach when rules are rigidly imposed by a powerful trade partner. Ownership can be enhanced through cooperation and stakeholder involvement, which would be part of a process of identification of adapted regulatory solutions for liberalization (Hoekman 2010). This is in a

way related to the respect of country preferences and a mechanism of reduction of differences towards agreeing on mutual recognition.

Thus flexibility seems an important dimension to consider for deep integration dimension. Hence the recommendation for “living agreements” incorporating a work program and associated institutions that establish a pathway allowing deeper integration over time and the resolution of standards issue. Hoekman (2010) similarly argues in favor of a constructive versus adversarial process in North-South PTAs. Also, a problem with purely adversarial procedures is that they tend to leave unaddressed public good type of issues whereas supranational institutions have an incentive to take this forward. PTAs then become instruments of cooperation in addition of integration, and can provide a “problem solving” forum to countries undertaking reform and upgrading their regulatory capacity.

Another aspect of the flexible approach to deep integration is the implications on approaches to dispute settlement. On the one hand, negotiating and implementing deep integration dimensions is costly and this provides a motive for ensuring a return on this investment by having strong dispute settlement mechanisms (Porges 2010). This may explain the observed trend towards more legalistic forms of dispute resolution, replacing more diplomatic approaches of older agreements. In this regard, the solution of WTO-like *ad hoc* panels (which allows among other things to draw on the expertise of specialists) is often preferred. On the other hand, dispute settlement is only one of the several mechanisms in PTAs contributing to enforcement. Panel type disputes are only in exceptional cases, and smaller disagreements are resolved through other channels established in PTAs. The latter is what can be described as soft law. In this respect, common institutions play an important role, allowing technical and *ad hoc* approaches to solving what are often complex issues. This also enables to involve third parties such as the private sector more easily.

As already indicated, the extent to which a PTA is symmetrical or not – among partners of equal level of development or economic size – has implications on the choice of degree of flexibility and informality. In this sense, a flexible approach can very much be seen as a building block towards more formal arrangements down the line. Porges (2010) notes that dispute settlement tend to become more legalistic when the relationship is symmetric, whereas in the case of asymmetry political and diplomatic approaches are preferred. While this may be construed as a

way to provide flexibility to smaller partners and to reflect the unequal balance of power, it leaves also the solving of dispute to less transparent conduits where power wielding may be easier to use.

3.4 It's about implementation

The insufficiency of a solely legalistic approach to commitments implies that negotiations will not settle every issue, and that in addition to the *ex ante* work of negotiators, an important *ex post* agenda awaits countries signing PTAs. It can be argued that the implementation agenda is *on paper* more important in the case of PTAs than it may be in the WTO. There are essentially two reasons to that. The first one is that PTAs commits parties to effective liberalization, when the WTO often only commits parties to bind only maximum levels of protection and provides numerous exemptions and exceptions for developing countries.²⁹ The second reason is that deep PTAs cover new and more ambitious ground than does the WTO.

In some areas the track record of PTAs in implementation has been relatively poor. Review of services (Mattoo and Sauvé, 2010), and competition provisions (Dawar and Holmes, 2010) suggest unimpressive records, while in areas where there have been more pressures towards implementation such as IPRs, the evidence shows much more substantial changes (Biadgleng and Maur, 2010). The different treatment received in IPR is the direct result of implementation and enforcement being features that have gained prominence in recent PTAs involving the U.S. and Europe.

Dealing with deep integration issues require preparedness that goes well beyond the negotiation stage, and most likely dedicating some permanent resources to managing the agreement. The resource and policy implications of deep integration agreement are likely to be in part unforeseen, as Hoekman (2005) suggested, and this may be compounded by the lack of preparedness of countries. Examples of possible unintended consequences of commitments include incompatibilities between PTA commitments and existing (domestic and international)

²⁹ In terms of liberalization, PTAs will at least lock in the *status quo* if disciplines in an area are included. This is furthered by the use of negative list approaches such as in some services provisions. Thus the value of commitments in PTAs is higher than in the WTO. In this sense PTAs are more rigid. This may a reason why developed countries have intensively used PTAs with smaller developing countries, as a way to lock-in liberalization in a way that was not necessarily happening in the WTO. This means in return that with stricter commitments looming, resistance to liberalization may also be stronger.

legal environment;³⁰ political economy constraints where commitments are not accepted by domestic constituencies (including legislators that may have to vote on new laws); limitations to regulatory freedom; inefficiency in implementing the new regulatory environment; and economic implications that are less beneficial than initially thought.

One implication of regulatory dimensions is that beyond the principle of liberalization agreed in the PTA, a work program of implementation must be devised in order to make this a reality. The implementation of the provisions of an agreement may require different levels of intervention. First institutional changes may be required, as implementation of new areas of policy may call for setting up new regulatory agencies or the reorganizing of existing institutions. Second, regulatory reforms: the drafting of new laws will be required to reflect PTA commitments. This will vary depending on the legal standing of international commitments in domestic law (some require translation in domestic law while others have direct effect; also some law systems rely more on case-law approach). The third dimension of implementation consists of the administrative, procedural and operational changes required to comply with the new regulatory framework. This can include also the management itself of the agreement, including transparency, and monitoring requirements. Finally, enforcement of the newly adopted regulations needs to be considered. This relates also to the allocation of staff and resources to guarantee that the law is applied. “Quality” of enforcement considerations also applies, with measures of the effectiveness of how laws are applied (from Biadgleng and Maur, 2010).

Since the text of the PTAs is only one starting element of the process of integration, implementation aspects must also be carefully examined to see whether liberalization is effective or not. Monitoring and accountability matter. This is a more complex process than verifying that trade barriers are effectively dismantled, and for which information is often not readily available. In general implementation in PTAs is not a very transparent process, and sustained attention to implementation is rare. This is an additional reason speaking in favor of taking a constructive cooperative approach argued by Hoekman (2005) given the complementarity between information generation and exchange, and the process of “discovery” of the best trade facilitating regulatory solution.

³⁰ Biadgleng and Maur (2010) report the example of Egypt taking some commitments with the EU to ratify the International Union for the Protection of New Varieties of Plants (UPOV) Convention for the Protection of New Varieties of Plants, in contradiction with its own law.

In spite of some evidence of monitoring,³¹ information about implementation remains scarce and most of the analysis of PTAs rests on the evidence provided by the agreements themselves and some measures of outcomes such as trade flows. While such analysis provides useful insights, the policy recommendations that can be drawn from such analysis is limited. Little is known about which liberalization strategies work best as agents of change, and for instance which of the hard law, soft law approaches or combination thereof contribute most to liberalization. The inference from the above discussion is that while there are now many examples to refer to, and distinctive types of approaches to integration, there is still relatively little to recommend in terms of how to appropriately implement deep integration provisions in PTAs beyond a core set of principles.

For developing countries, one attraction of PTAs with more developed partners is the prospect of access to capacity building and transfer of resources, at least in theory. Whether and how development assistance contributes to implementation is generally difficult to assess, and even more so in the context of PTAs given the naturally nontransparent nature of institutional dimensions.

One important dimension that appears notably in the discussion on competition policy, government procurement and standards is to what extent the process of implementation should be driven from the centre or not. For instance, competition regimes in PTA contexts range from regional institutions to national institutions cooperating on international issues. Several considerations come into play affecting whether the implementation process will be left to national government or devolved to a transnational body (Dawar and Evenett, 2010).

The first obvious point is that a prerequisite to common institutions or rules is the willingness of trade partners to abandon some of their sovereignty. When this is not the case (for instance often in context of North-South agreements), only “lighter” options remain, and only core principles guaranteeing good policy and governance can be agreed. This is for instance the solution chosen for procurement provisions. A related concern is the choice between maintaining national preferences and adopting international standards. In the context of standards as well, the answer

³¹ Examples are the USA which “certifies” implementation of FTAs before Congress approval, the EU which reports regularly in the case of accession and in more *ad hoc* fashion with other partners on implementation, APEC implementation action plans, and South-South agreements such as Comesa, where the Secretariat monitors country progress.

to the question of harmonization vs. recognition depends on whether the benefits of harmonization outweigh the costs of loss of preferences. National ability to issue regulations is also a parameter to take into account. In particular, one dimension of preserving diversity in regulation and implementation is to derive the benefits from competition between different regulatory solutions and procedures. Messerlin and Zarrouk (2000) advocate for less centralization in the context of conformity assessment in order to promote competition between different conformity services.

A second point is the degree of coordination that is required by the integration policy. For some transnational public goods, common institutions and a top-down approach may be required in order to solve the coordination problems that lead to inadequate supply of the goods. Beyond public goods *per se*, common institutions appear in particular necessary when frequent interactions, decision making, adjudication, and exchange of information is needed such as for instance in customs unions. A related dimension is the desire to achieve certain scale/efficiency effects. Competition policy illustrates the possibility of opting for a common centralized competition regime (such as in the case of the EU, Caribbean, Comesa, Andean Pact) when parties of a PTA do not differ much in terms of preferences over the type of competition enforcement.

For developing countries in particular, a top-down approach may prove more attractive. A first incentive might be to improve governance. By decentralizing decision making within a PTA, member countries may be able to better anchor policies from the risk of reversal and guarantee its independence. Competition policy is a good example of this strategy, where it might be difficult in some countries to escape the influence of particularly large firms and thus discipline them. More generally anchoring could for instance be a rationale for countries with weak judicial systems to rely on supranational judicial institutions. Poor administrative resources at the country level could also motivate the pooling of resources among a group of countries, as small islands countries have done. Third efficiency motives may lead some countries to seek to replace their existing regulations by superior systems “imported” from partner countries and through the institutional mechanisms of the PTA get access to the superior expertise and systems of the partner country.

4 Conclusions

Modern PTAs are fast evolving. They are increasingly deep and affect all countries and regions of the world, including the most remote quarters. As academics and policy makers try to deal with this new generation of PTAs, a few tentative conclusions can be made on this changing landscape.

First, deep integration introduces a change of paradigm. To be sure PTAs are still about preferences, discrimination, and exclusion. They could lead to sub-optimal outcomes and could complicate and even undermine progress toward a more open, rules-based, and non-discriminatory multilateral trading system. More worrying than discrimination perhaps is the additional inherent complexity that is created by overlapping and conflicting regulatory regimes promoted by myriads of PTAs. This concern is already clearly identified and the call for multilateralizing regionalism already voiced in the WTO (Baldwin and Low 2009). The concern that PTAs “compete” with multilateral negotiations for the attention of negotiators and that they provide an untidy way of proceeding to liberalization remains legitimate.

Yet, one chief emerging lesson is that the economic paradigm of shallow PTAs does not necessarily apply to deep and comprehensive PTAs. “Old” concepts such as mercantilist reciprocal liberalization, trade creation and diversion, or a textual approach to signing PTAs may still underpin the reasoning of many policy makers but are often obsolete or incomplete for deep integration liberalization. Failure to understand the new paradigm of preferential integration may in turn explain why most PTAs have either not exploited to the full the liberalization opportunities of behind the border measures or not prioritized the one closest to the parties’ interests – although it might be naïve to put solely the lack of progress to a lack of understanding.

Second, deep integration PTAs are potentially powerful “tools” to push wide-ranging government-owned reforms. Beyond market access, deep integration PTAs create opportunities to complement trade liberalization with other behind the border reforms. And they offer unique instruments to promote bilateral or plurilateral cooperation and resource transfers, transparency mechanisms, mutual equivalence, informal mechanisms for dispute resolution, in-depth and expert dialogue, and deeper liberalization among the willing ones. These are not approaches that can be easily – or at all – replicated in the large and formal setting of multilateral institutions.

Yet PTAs are worthwhile only if governments are themselves committed to reform and liberalization. PTAs offer a variety of mechanisms by which the process of reform will become more effectively and irremediably set in motion, but a prerequisite is that meaningful commitments be agreed to in the first place. Deep integration PTAs should therefore strive to provide open access to any regulatory rules and discipline to ensure equality of treatment of all members and non-members so as to minimize the occurrence of “regulatory preferences”. This means beyond national treatment, liberal rules of origin, transparency, and the availability of due process. Good regulatory practice should lead to *de jure* preferential liberalization to becoming MFN liberalization in effect. The question of discrimination is likely to remain tortuous, even if it appears less visible than for tariffs. Discriminatory regulations could take many forms, be it codified or not in rules (e.g. *de facto* preferences can arise from rules that look non-preferential on paper, or from preferential enforcement). Furthermore, discrimination may also paradoxically be the only form of acceptable liberalization, such as with mutual recognition.

Third, deep integration should be pursued in a strategic and selective manner. Another answer to complexity, not sufficiently considered by developing countries in our view, is selectivity (this is also something suggested by Hoekman and Sekkat, 2010). Liberalization is a complex matter, not only from a capacity standpoint, but also politically. The political economy of deep integration involves many (often opposing) interests and a large set of potential stakeholders. Overloading the negotiating agenda (which will later on become the implementing agenda) keeps the focus away from what may be achievable and where gains may be the most important. Agreements bloated by too many issues may lose significance and fail to achieve much.

On the other hand, picking meaningful issues with the right partner and adequate technical assistance and cooperative approach may result in substantial liberalization progress and serve as a positive signal or trigger for more challenging areas. Market access should not be the only item on the agenda of negotiators, especially those of developing countries, since deep integration is really about thinking of a domestic reform strategy. In this respect too, prioritization of core objectives and sequencing should be central consideration of negotiators. And sound regulatory practice should underpin liberalization to minimize the occurrence of “regulatory preferences” and ensure the overall consistency of liberalization and regulatory objectives.

And fourth, there is no one-size-fits-all deep integration. As policy makers start integrating more and more these new dimensions, we can expect that they will become more intensive “users” of PTAs to further liberalization objectives, hopefully in complement to multilateral efforts. Liberalization in each sector is not a simple matter and escapes easy characterization, as well as one-size-fits-all types of answers. This complexity means that there are few universal rules to follow, mainly carefully designed and specific solutions. Deep integration is essentially a *sui generis* process as for instance illustrated by Winters (2010) in the case of the EU. Yet, complexity means that some core principles should be followed to promote to the extent possible market-based solutions.

The dynamics of North-South, South-South and North-North PTAs differ considerably. Asymmetric agreements make cooperation less easy and may provide less scope for transnational public goods, mutual recognition, but more prospects of lock-in, and access to imported regulatory regimes when needed. Market access considerations will be overbearing for the small partner, whereas the larger partner will seek beyond that to diffuse its regulatory norms, including values norms, and trigger competitive liberalization effects in partner countries. A related logic can be observed with the European Union, which attempts to leverage its PTAs to shape South-South agreements in recent wave of agreements with the Mediterranean countries, the Balkans and the ACP countries (Maur, 2005).

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